SUPREME COURT, U. S.
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IN THE

Supreme Court of the United States

October Term, 1955

No. 255

MILLINERY CENTER BUILDING CORP.,
Petitioner,

v.

COMMISSIONER OF INTERNAL REVENUE,
Respondent.

ON WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

REPLY BRIEF FOR THE PETITIONER

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In The

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No. 255

Millinery Center Building Corp.,
Petitioner,

v.

Commissioner of Internal Revenue,
Respondent.

On Writ of Certiorari to the United States Court of Appeals for the Second Circuit

REPLY BRIEF FOR THE PETITIONER

I.

The respondent in his brief on the merits fails to recognize that the questions that the Court has agreed to review require something more than mere assertions to establish the law to be applied to the facts of this case.

The respondent first asserts that the amount paid to the landlord by the taxpayer to purchase the fee and cancel the lease was a capital expenditure and then argues that capital expenditures must be depreciated over the economic useful life of the asset.

But it is the very question of capital expenditures versus ordinary and necessary deduction that is at issue. Taxpayer does not contend that cost of capital assets may be deducted in the year of acquisition. With the illustrations given by respondent on page 11 of his brief, the taxpayer has no dispute; it does not contend otherwise. But the facts in those illustrations and the precept of law applied thereto do not fit the facts in the instant case. The facts in *Herzberg* v. *Alexander*, 5 F. Supp. 334, *Boos* v. *Commissioner*, 30 B. T. A. 882, and *Post* v. *Commissioner*, 109 F.2d 135, have already been distinguished in petitioner's brief. It should be noted, however, that respondent's brief statement of facts in the *Post* case is misleading since the property in that case was transferred by the lessor-owners to a new tenant-corporation owned by the lessors who received all of the stock and securities of the "purchasing" corporation. Furthermore, the demolished old buildings of the lessor had been replaced by a new modern building by the original tenant and the lessor instead of an economic loss had in fact a real economic gain.

The respondent questions that the terms of the lease were in fact onerous or unreasonable. The language of the Tax Court was plain on this point when it stated: "Petitioner purchased the fee to be released from the terms of the lease. Petitioner was most concerned about the annual rental of $118,840, which it deemed excessive, and the contingent liability to remove the building from the premises at the expiration of the lease upon the request of the landlord." (R. 5)

The original lease called for a renewal rent equal to 6% of the value of the land, vacant and unimproved, in 1945, but not less than the basic rent of $100,000 plus $18,840.

(R. 5) If not for the minimum rent clause, the renewal rental would have been 6% of $650,000, or $39,000. Competent, authoritative and uncontradicted evidence set the fair market ground rental in 1945 between $35,000 and $40,000.

Petitioner urges that as a matter of law a condition in a lease which requires the tenant to pay three times the fair rent for the premises or to forfeit a building which tenant constructed and owned at a cost of $3,000,000 and still had an agreed remaining economic life of 30 years, must be deemed, by its very requirement, to conclusively establish a burdensome or unreasonable lease.

Fine phrases and glittering generalities gleaned from other cases or illustrations involving different facts cannot convert a payment to get rid of such a lease from an expense into a capital expenditure. It was to rid itself of this burden of excessive rent as well as other catastrophic contingencies which induced the taxpayer to pay $2,100,000 for land worth $660,000. Certainly petitioner was not paying such a difference for the right to use the building for an additional nine years beginning 21 years later.

Respondent's distinction of the decisions in *Cassatt v. Commissioner*, 137 F.2d 745 and *Denholm & McKay Co. v. Commissioner*, 2 BTA 444, on the ground that in those two cases the tenants gave up the premises, whereas petitioner in this case was acquiring the fee, overlooks the essential that here petitioner was paying full measure for the land of $660,000. Cases cited by petitioner in its brief adequately support the basic proposition that a single payment may encompass both the purchase of an asset and the payment of an expense, without becoming merged into one another.

Respondent's alleged principle of merger was repudiated by U. S. Court of Appeals, 6th Circuit, in *Cleveland Aller-*

ton Hotel Inc. v. Commissioner, 166 F.2d 805. The facts and issue found in that case are similar to those in this proceeding and that Court's analysis of the facts and contentions of both parties as well as its reasoning in its opinion are equally applicable here.

Respondent argues (R. B. 9) that taxpayer's contention confuses the motive of purchase with what was purchased. Petitioner replies that business motive often is determinant of the tax treatment to be accorded any transaction. This fact has been amply supported by citations in petitioner's brief. (pp. 15-17) Recently, this honorable Court held that what ordinarily would be considered capital transactions, the purchase and sale of commodity futures, were to be treated as ordinary business transactions where said transactions were associated with the conduct of regular business. *Corn Products Refining Co. v. Commissioner*, (Nov. 7, 1955).

Respondent states (R. B. 15) that "taxpayer, which was obligated to pay rental of nearly $2,500,000 over a 21-year term, purchased for $2,100,000 fee to the land upon which there was a building erected at a cost of $3,000,000. Taxpayer thereby acquired ownership of the fee and of a building having a remaining useful life of thirty years."

Respondent has, unfortunately, overlooked the fact that taxpayer was the one who had erected the building and was already the owner of it. The taxpayer did not have to pay again in 1945 to acquire its ownership. While taxpayer's ownership in the building was subject to a lease, the lease still had 21 years to run and the taxpayer was enjoying the possession and use of such building. Even the additional nine year life after expiration of the 21-year lease was available to the taxpayer who at its option could renew the lease

for an additional 21 years. No purchase price for the building was required in 1945. The payment in excess of the value of the land of $600,000 was to save the very $2,500,000 rent referred to by respondent which was due over the next 21 years.

Respondent's statement that taxpayer's payment of $2,100,000 was in part for land likewise overlooks the fact that taxpayer had under its lease the complete use and enjoyment of the land for 21 more years and an option to renew for an additional 21 years. The only interest of the landlord in the fee that could be sold to and enjoyed by any purchaser was its use and enjoyment after the termination of Millinery Center lease at least 21 years later and possibly 42 years later. That this is so was recognized by Court below when it stated the taxpayer acquired a reversionary interest in the land. (R. 19).

Respondent argues (R. B. 16) that it is incontestable that taxpayer has acquired the right to use the building for the rest of its useful life and by deducting depreciation in each year the taxpayer will report undistorted income. As aforestated, taxpayer had the right to use its own building under the lease for at least 21 years. With regard to respondent's desire for undistorted income, the "right hand apparently does not know what the left hand is doing." The Office of Chief Counsel of Internal Revenue Service has advised the taxpayer that it interprets the decision of the Court below to give the taxpayer a building valuation of approximately $185,000 to spread over 30 years. Such amount is the alleged reversionary value of the building 21 years later with a remaining life of 9 years, discounted at 5% per annum to arrive at present value. Such treatment allows a depreciation deduction of approximately $6,200

per annum to offset the elimination of rent of $118,840 per annum and at the end of 30 years, taxpayer will have land costing $1,915,000 ($2,100,000—$185,000) but only worth $660,000, an unrealistic economic result. Taxpayer considers such contemplated treatment by respondent as being extremely distorted.

II.

Respondent misinterprets the taxpayer's theory of depreciating that part of payment of $2,100,000 in excess of the value of land of $660,000 over a 21-year period. Respondent's illustration of assumed purchase of property in March 1945, one month before the expiration of the first term of the original lease, may be analyzed as follows:

Taxpayer owns a valuable building worth about $1,800,000 which taxpayer will lose in one month unless it does something. That something is either to buy the fee or renew the lease. It buys the fee. The amount paid in excess of the value of the land then was to protect what it already owned, the building, and not to acquire a new asset. A payment made in the course of business to protect what one has as distinguished from acquiring a new asset may be deducted as an ordinary and necessary expense in accordance with Section 23 of I. R. C. The deduction in one year would not be as depreciation as stated by respondent.

An alternative construction that may be placed upon such a purchase of the property is that the excess payment was made to avoid renewing the lease and incurring aggregate rental of $2,500,000 over the next 24 years. Such a construction would also give a deduction in one year, as a payment made to avoid an unfavorable lease, a business

purpose, or be a capital asset to be amortized over 21 years, the period benefitted.

It should be noted that under the assumed set of facts, if the building were considered the asset acquired, the basis would be its relative value at time of purchase and not the present discounted value of a depreciated building 21 years hence.

Conclusion

The facts in this case, their analysis, the legal arguments in petitioner's brief as well as the arguments in this reply brief amply support the relief prayed for by the taxpayer; namely, that the amount of $1,440,000 be allowed as a deduction in 1945 or, alternatively, be amortized and allowed as deductions over the 21-year period of the extinguished lease.

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No. 258

In the Supreme Court of the United States

OCTOBER TERM, 1955

MISSOURI CRUSHED STONE CORPORATION, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE EIGHTH CIRCUIT

MEMORANDUM FOR THE RESPONDENT

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In the Supreme Court of the United States

OCTOBER TERM, 1955

No. 255

MILLINERY CENTER BUILDING CORPORATION, PETITIONER

v.

COMMISSIONER OF INTERNAL REVENUE

ON PETITION FOR A WRIT OF CERTIORARI TO THE UNITED STATES COURT OF APPEALS FOR THE SECOND CIRCUIT

MEMORANDUM FOR THE RESPONDENT

OPINIONS BELOW

The opinion of the Tax Court (Pet. 20-28) is reported at 21 T.C. 817. The opinion of the Court of Appeals (Pet. 31-35) is reported at 221 F. 2d 322.

JURISDICTION

The judgment of the Court of Appeals was entered on April 14, 1955. A petition for a rehearing was denied on May 18, 1955. (Pet. 49.) The peti-

tion for a writ of certiorari was filed on July 22, 1955. The jurisdiction of this Court is invoked under 28 U.S.C., Section 1254.

QUESTIONS PRESENTED

1. Taxpayer, as lessee of certain land, erected a building thereon, and, after renewal of its lease, purchased the fee. The first question is whether the taxpayer could, in the year of the purchase, deduct as an ordinary and necessary business expense under Section 23 (a) of the 1939 Internal Revenue Code the difference between the price paid for the property and the value of the land vacant and unimproved.

2. If taxpayer is not entitled to such deduction, whether it can amortize this sum and certain legal expenses incident to the purchase agreement over a period of 21 years, inasmuch as the renewed lease would have run for that period if it had not been cancelled at the time of the purchase.

STATUTE INVOLVED

Internal Revenue Code of 1939:

SEC. 23. DEDUCTIONS FROM GROSS INCOME.

In computing net income there shall be allowed as deductions:

(a) [as amended by Sec. 121 of the Revenue Act of 1942, c. 619, 56 Stat. 798] *Expenses.*—

(1) *Trade or business expenses.*—

(A) *In general.*—All the ordinary and necessary expenses paid or incurred during

the taxable year in carrying on any trade or business * * *.

* * * * *

(l) [as amended by Sec. 121 of the Revenue Act of 1942, *supra*] *Depreciation.*—A reasonable allowance for the exhaustion, wear and tear (including a reasonable allowance for obsolescence)—

(1) of property used in the trade or business, or

(2) of property held for the production of income.

* * * * *

(26 U.S.C. 1952 ed., Sec. 23.)

STATEMENT

The pertinent facts as found by the Tax Court, (Pet. 15-29) are as follows:

Taxpayer leased land in New York City on April 30, 1924, and in accordance with the terms of the lease erected a 22-story building thereon at a cost of $3,000,000. Title to the building belonged to the taxpayer but was to vest in the landlord at the expiration of the last term of the lease at the option of the landlord. In the event of the destruction of the building by fire or other causes, the taxpayer could not abandon the lease and had to restore the building at its own cost. At the expiration of the lease or any renewal period, tax-

payer was to surrender the premises and the building to the landlord at the latter's option, free and clear of all encumbrances, without the landlord being obligated to pay for such property. (Pet. 15-16.)

The Commissioner allowed the taxpayer during the 21-year term of the original lease the entire cost of the building in annual depreciation deductions. (Pet. 27.)

Taxpayer had the option to renew the lease and did renew it on April 16, 1945, for another 21-year period. (Pet. 15-16.) The ground rent for the renewal period was to be six percent of the value of the land at the termination of each period of the lease but not less than the previous rental of $118,840. The value of the land was to be determined as if vacant and unimproved and the rent at six percent of the value of the land in May 1945 would have been less than $100,000. (Pet. 16.)

On May 11, 1945, taxpayer purchased the fee and obtained release from the obligations of the renewed lease for $2,100,000. Taxpayer purchased the fee in order to be released from the terms of the lease. (Pet. 16.) Title to the land was taken by taxpayer on June 11, 1945. (Pet. 16.) On the same day the agreement cancelling the lease was executed. (Pet. 18.) Taxpayer incurred legal fees aggregating $16,500 in connection with the purchase of the fee and the release from its obligations under the lease. (Pet. 20.)

The value of the land, vacant and unimproved,

apart from the taxpayer's building, was $660,000 when purchased by taxpayer in 1945. (Pet. 20.)

The Tax Court held (Pet. 21-28) (1) that the taxpayer was not entitled to deduct any part of the sum of $2,100,000 paid under the 1945 agreement as a business expense, (2) that the taxpayer could not amortize any part of such sum over the 21 years during which the renewed lease would have been in force if it had not been cancelled, and (3) that the taxpayer was not entitled to treat any part of the sum paid as an addition to the cost of the building which it had erected on the land as lessee, and so could take no additional depreciation because of payments under the agreement.

The Court of Appeals agreed with the Tax Court on the first and second points but held on the third point that the taxpayer had purchased a reversionary interest not only in the land but also in the building, and was entitled to allocate a part of the purchase price to the building to be deducted as depreciation. The Court of Appeals found that it could not determine how much should be allocated to the building since the record showed only the value of the land in its unimproved state and not its present value. Accordingly, the case was reversed and remanded for the Tax Court to determine the amount to be depreciated. (Pet. 32-35.)

DISCUSSION

We believe that the courts below were correct in holding (1) that the taxpayer was not entitled to deduct the asserted difference between the pur-

chase price of the fee and the value of the land as an ordinary and necessary business expense, even if the lease was onerous, and (2) that the taxpayer could not amortize this difference over the remaining years of the cancelled lease. However, the Court of Appeals for the Sixth Circuit, on substantially identical facts, has held that the lessee-purchaser is entitled to the business-expense deduction the taxpayer here was denied. *Cleveland Allerton Hotel v. Commissioner*, 166 F. 2d 805. Both the court below (Pet. 33) and the Tax Court (Pet. 24) have recognized that their conclusion in the instant case is contrary to that of the Sixth Circuit. In view of this conflict, and because the problem presented bears on the fundamental criteria for distinguishing under the tax laws between capital expenditures and ordinary expenses, we do not oppose the granting of certiorari.

While the conflict, strictly speaking, affects only the first of the questions petitioner presents, the nature of the problem is such that denial of the expense deduction logically entails a determination of what depreciation allowance, if any, is proper. Accordingly, we do not propose that the writ be limited to the first question. It is to be observed, however, that the taxpayer prevailed on the third question stated in its petition (Pet. 2)—*i. e.*, it was allowed by the Court of Appeals to depreciate the value of the building over its remaining economic life—and we do not seek review of this determination. Since there is thus no issue

here as to the correctness of the decision below on this question, there is no occasion for this Court to reach and review it.

CONCLUSION

For the reasons stated, we do not oppose the granting of certiorari limited to the first two questions the petition states—namely, whether the taxpayer was entitled (1) to the expense deduction it claimed or (2) to depreciate the difference between the cost of purchasing the fee and the value of the land over the remaining years of the cancelled lease.

Respectfully submitted.

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